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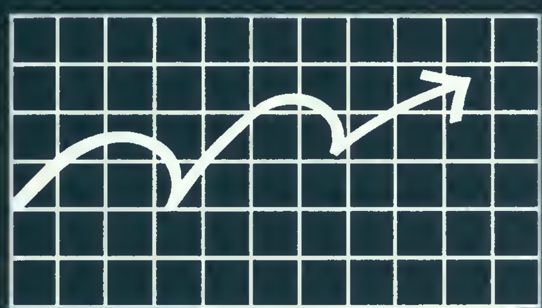

POTENTIAL USES OF THE COAL TAX TRUST FUND FOR ECONOMIC DEVELOPMENT

1986 UPDATE

SUBMITTED BY THE MONTANA ECONOMIC DEVELOPMENT BOARD

MONTANA DEPARTMENT OF COMMERCE

Build Montana

MONTANA ECONOMIC DEVELOPMENT BOARD

DEPARTMENT OF COMMERCE

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October 1986

TO THE PEOPLE OF MONTANA:

The 1983 Legislature gave the Montana Economic Development Board (MEDB) the following charge:

> 17-6-323. Report of potential uses of Coal Tax Trust Fund. The Board shall prepare for each regular session of the Legislature a report on potential uses of the Coal Tax Trust Fund to develop a stable, strong, and diversified Montana economy that meets the needs of present and future generations of Montanans while maintaining and improving a clean and healthful environment as required by Article IX, Section 1, of the Montana Constitution.

The MEDB's first report, delivered to the 1985 legislature, identified four key issues which the MEDB felt merited further in-depth study and discussion by the legislature and executive branches and by the people of Montana:

* The steady erosion of the purchasing power of trust deposits -- a problem exacerbated by the increasing reliance being placed on coal trust fund interest and income to support the state's general fund;

* The narrow range of management options available to the fund's trustees (the Board of Investments and the MEDB);

* The relatively limited use of the trust for in-state investments; and

* The lack of criteria and procedures for objectively evaluating proposals for appropriation of all or a portion of the trust's principal.

In the two years since that report was issued, there has been disappointingly little progress made toward resolving those problems.

Although a declining inflation rate has slowed somewhat related purchasing power losses, those small gains have been offset by new negative factors -- declining coal sales, increasing water bond principal drawdowns, and projected lower rates of return on trust investments. Using current Consumer Price Index (CPI-U) estimates, the $245.5 million in trust deposits made from 1978 - 1985 will have lost 127.5 million in purchasing power (50.4% of total value) by the Year 2000.

While purchasing power has been shrinking, general fund reliance on trust income has continued to grow. In 1978, 0.09% of the general fund was derived from trust earnings. By 1982, the figure had climbed to 3.6%, and in 1986 it was 9.3%. Unless the principal of the trust increases substantially, future earnings will be inadequate to maintain the trust's current proportional share of the revenue needed to meet general fund demands.

One way to supplement the principal is through increased deposits--resulting from more coal sales, redeposit of more than the current 15% of trust earnings and income, or deposit into the trust of more than 50% of coal severance tax revenues. Another, more realistic, way to stimulate trust earnings is to increase the rate of return on trust investments. The 1985 legislature opened this door somewhat by eliminating the "laundry list" of permissible investments for state fund managers and adopting in its place the "prudent expert" standard, both steps having been urged in the 1985 MEDB report.

Unfortunately, however, no action was taken on the MEDB's recommendation that the voters be asked to consider a constitutional amendment to permit the investment of some coal trust funds in equities. We believe that action is still needed.

The objectives for trust investment mandated by the voters through the 1982 passage of Initiative 95 are "to diversify, strengthen and stabilize the Montana economy and to increase Montana employment and business opportunities ..." Whether the trust is being used as effectively as it might be to achieve those ends is doubtful, and both the 1985 report and this year's update suggest numerous ways to address that issue.

When the 1985 report was prepared, proposals for appropriation of trust principal were relatively rare. Foreseeing a time when circumstances might change, the MEDB urged then that an effort be made to identify and adopt suitable criteria to be used by the legislature in making that critical determination on behalf of the trust's beneficiaries. We further called for the establishment of a careful deliberative process through which all proposals for the use of trust principal would be reviewed and evaluated. No action was taken on our recommendation by the legislature. Governor Schwinden did suggest the subject to his Council on Economic Development for their consideration, but they did not make it a part of their 1986 work program.

Given the recent proliferation of proposals to use the trust to cover general fund shortfalls or otherwise meet the demands of on-going

government expenses, the MEDB believes the lack of objective appropriation criteria has become a critical deficiency.

Two years ago the MEDB recommended that the legislature commission a public discussion of the management and uses of the coal tax trust fund, with a report containing the results of that process and recommendations for action being submitted to the next legislative session. We continue to believe that that course of action is needed. Because of the still partially untapped capacity of the trust to provide vast economic benefits to present and future generations, and because of the real possibility that the true potential of the trust has yet to be realized, the state would be remiss if it failed to examine seriously its options.

Unfortunately the MEDB does not have the financial or staff resources needed to bring about and support that public discussion. As our final recommendation, therefore, we urge that the responsibility for initiating that process and for preparing in future years the reports called for in section 17-6-323 be transferred from us to the Governor's Council on Economic Development or another more broadly based and appropriately funded body which can give to the issues surrounding the coal tax trust the time, visibility, and careful consideration they so urgently need and greatly deserve.

Sincerely,

D. Patrick McKittrick

D. Patrick McKittrick
Chairman

/dlm

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INTRODUCTION

In early 1985, the Montana Economic Development Board submitted the first "Report of Potential Uses of [the] Coal Tax Trust Fund" it is required to prepare for each regular session of the Legislature under Section 17-6-323.

Because of the seriousness of the issues and problems it identified in the course of putting the report together, the MEDB urged the Legislature to commission a public discussion of the management and use of the trust, with a report of the results to be submitted to the 1987 Legislature.

Unfortunately, however, no such action was taken, although a few of the specific suggestions for changes raised in the 1985 Report did receive positive legislative consideration. The larger, and more important, questions -- trust management, loss of trust purchasing power, principal appropriation criteria, etc. -- were left unaddressed.

This year's Report is an update of the 1985 one, and is meant to be read in conjunction with it. [Copies of the 1985 Report are available on request from the Montana Economic Development Board, Department of Commerce,Room 50, 1520 East Sixth Avenue, Helena, Montana 59620-0505] Key charts, tables, and projections have been revised and/or updated, and legislative or administrative actions taken on issues identified in 1985 have been noted.

Events of the intervening years which have sharpened or further defined the problems surrounding the trust are discussed briefly, as are their impacts on trust management. Some of these include the worldwide drop in oil prices and its effect on coal sales, the new "window of opportunity" in coal severance taxes, the substantial state revenue shortfalls which have generated numerous proposals for principal appropriations from the trust, and the failure of many of Montana's basic industries to recover fully from the most recent U. S. economic downturn.

In analyzing these problems and evaluating possible solutions, the MEDB (lacking other legislative direction) has used criteria of its own formulation. The Board is not comfortable doing this -- not because it lacks faith in its own judgment, but because its members feel strongly that more than seven individuals should be actively involved in the development of principles guiding the management and use of a fund that, by the end of the century, could total more than $1 billion in assets and that is supposed:

1) to compensate future generations for the loss of a valuable and depletable resource and to meet any economic, social, and environmental impacts caused by coal development not otherwise provided for by other coal tax sources; and

> 2) to develop a stable, strong and diversified economy which meets the needs of Montana residents both now and in the future while maintaining and improving a clean and healthful environment . . . . [17-6-303]

The MEDB transmits this report to the 1987 Legislature with the hope that its suggestions and recommendations will be favorably considered. It also urges, however, that the responsibility for carrying out Section 17-6-323 in future years be transferred from the MEDB to the Governor's Council on Economic Development or another, more broadly based and appropriately funded and staffed body. MEDB members feel this would give the question of alternative approaches to management of the coal tax trust fund the time and visibility it so greatly needs and deserves.

CHAPTER 1

PURCHASING POWER EROSIONS

A. Future Decreases in Trust Earnings Rates

The Montana Economic Development Board's report to the 1985 Legislature on potential uses of the coal tax trust fund (hereinafter referred to as "the 1985 Report") identified four key issues (not listed in order of priority) which the MEDB felt merited extensive further public exploration and debate:

1) The steady erosion of the purchasing power of trust deposits, a problem exacerbated by the increasing reliance on trust fund interest and income to support the state's general fund;

2) The narrow range of management options available to the fund's trustees (the Board of Investments and the MEDB);

3) The relatively limited use of the trust for in-state investments; and

4) The lack of criteria and procedures for objectively evaluating proposals for appropriation of all or a portion of the trust's principal.

All four issues remain at least partially unaddressed, and two (purchasing power and principal appropriation) have been rendered even more critical as a result of the events of the last two years.

The foreword to the 1985 Report said:

> Presently [as of June 30, 1984] the principal of the permanent coal tax trust fund . . . stands at approximately $200 million. If earnings were to average only 12 percent (compared with the actual 14.15 percent average for the last four years), and if new deposits increased by 7 percent per year (compared with a 9.125 percent actual average for the last four years), by the year 2000 the total could be well over $1.8 billion. [1]

In Fiscal Year 1985 the income yield on the portion of the trust administered by the Board of Investments dropped slightly (to 13.99 percent); when the MEDB's portion is included the blended rate (not

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[1] Montana Economic Development Board, "Report on Potential Uses of Coal Tax Trust Fund for Economic Development", Helena, Montana, 1985, page 1.

including long-term benefit calculations) is 13.62 percent. In FY86, however, interest on the Board of Investments-administered portion was 15.58 percent. On the face of it this would appear to be good news. In fact, it is the beginning of an unexpected and ominous sharp downturn in the trust's fortunes.

At the end of FY84 the trust's portfolio of bonds included many paying interest rates of 14 percent to 16 percent -- with some as high as 17.5 percent. By year-end FY85, some of these were no longer in the portfolio, and in FY86 a significant outflow was occurring. The reason is that, given the present low interest rate environment (with New York prime at 7.5 percent on September 1, 1986), many high coupon bonds are being called away at premium. As of January 31, 1986, the book value of callable bonds was $106.8 million, with a premium to book of $12.8 million. In FY87, nearly half of the high rate bonds held by the trust are subject to calls.

In the short term, this produces high trust returns, but since actual capital gains are treated as income, and 85 percent goes to the state's general fund, the long range effect is to lower trust earnings. The principal of the trust will gain little, and the return on the investments it will hold will be less than at present (assuming that interest rates remain at below double-digit levels for some time).

What happened to interest rates? For one thing, world oil prices plummeted, sinking from $28 a barrel in the Fall of 1985 to $11 to $14 a barrel in July, 1986 -- with rates as low as $6 to $8 a barrel expected by Fall, 1986, unless OPEC acts to curb production. Even though rates are expected to rebound somewhat in the future (the Legislative Fiscal Analyst used a $15 per barrel price in calculating revenue shortfalls for the remainder of the biennium), the unforeseen and drastic drop has had a severe negative effect on coal production and sales.

B. Decreased Trust Inflows

1. Coal Sales

In FY34, 30.2 million tons of coal were mined, with severance tax collections of $82,823,411. In FY85, severance tax collections increased to $91,748,886 on production of 33.5 million tons, but that was nearly 8 percent below what the state had anticipated when revenue projections were made. FY86 sales of 31.2 million tons were near 1984 levels, and taxes collected were only slightly higher ($84,189,051). [The total tax liability was $84,471,768, but producers claimed $282,717 in tax credits -- $12,255 for a prior period correction, and $270,462 under the New Coal Production Incentive credit, the so-called "window of opportunity" created by the 1985 Legislature to stimulate coal sales.]

The seriousness of the situation and the magnitude of the extent to which the future of the trust is affected by circumstances beyond Montana's control is shown in the following chart. Column 1 shows the coal tax revenue projections which the Office of Budget and Program Planning was using in 1984. Column 2 shows current OB&PP projections (not adjusted for the New Coal Production Incentive Credit), while Columns 3 and 4 show the dollar and percentage differences.

PROJECTED COAL SEVERANCE TAX COLLECTIONS

Fiscal Year June 30	(1) 1984 Projections (in $000)	(2) 1986 Projections (in $000)	(3) Difference (in $000)	(4) Difference (%)
1985	$ 99,730	$ 91,749*	$ (7,981)	- 8.0%
1986	103,919	84,472*	(19,447)	-18.7%
1987	110,280	80,038	(30,242)	-27.4%
1988	117,742	82,664	(35,078)	-29.8%
1989	127,773	85,012	(42,761)	-33.5%
1990	140,261	83,404	(56,857)	-40.5%
	$699,705	$511,339	$ (188,366)	-26.9%

* Actual collections

2. Window of Opportunity

The New Coal Production Incentive Tax Credit Act of 1985 is codified at 15-35-2-1, MCA, and following sections. It was passed at the urging of Governor Ted Schwinden to provide coal producers an opportunity to prove to the state that lowered coal severance taxes would result in increased coal sales and, hence, greater tax revenues.

Coal producers and others have argued for many years that Montana's 30 percent (of contract sales price) severance tax is excessive and detrimental to the health of that basic industry. They maintain that the tax places them at a competitive disadvantage vis-a-vis producers in states (particularly Wyoming) with lower severance taxes, and that it is viewed by utility customers as usurious.

The state has responded that the tax is not excessive, and that its effective rate upon calculation is far less than 30 percent, closer in fact to 19 percent.

> Although over 99 percent of the coal currently [in 1985] produced in the State is taxed at 30 percent of "contract sales price," during 1983 the average effective rate at which the coal severance tax was imposed on the F.O.B. price of all coal produced in the state was 20.8 percent. The State's

> Department of Revenue estimates that after July 1, 1987, when the royalty deduction [described in the 1985 Report] reaches its final level, the overall effective rate of the coal severance tax will be approximately 18.5 percent, without reference to the [new coal production incentive tax credit]. . . . [2]

The state further argues that the portion of the delivered price per ton of coal which represents severance taxes is negligible in comparison with, for instance, transportation costs, and that total elimination of the tax would not greatly affect Montana producers' competitiveness.

The state also maintains that the 30 percent rate is necessary to fulfill adequately the purposes of a severance tax, which include:

> (1) Internalizing into the price of the resource some of the external costs of production (such as land productivity impairments; financial and social impacts on coal-area communities; air, water, or visual pollution; etc.);
>
> (2) Influencing the rate of use or development of the resource;
>
> (3) Capturing part of the economic rent associated with the extraction of a non-renewable resource (that is, the premium buyers will pay to obtain a scarce, non-renewable commodity); and
>
> (4) Compensating present and future generations for the loss of a part of their natural heritage. [3]

Thus, Montana uses coal severance tax revenues not only to fund the coal tax trust, but also to support programs for local impact mitigation, education, park acquisition, and water development, among others.

Still the anti-high-severance-tax argument has continued to receive credence in many quarters, and the tax is often cited as an example of the state's alleged anti-business climate.

The new coal production incentive tax credit was designed to give coal producers a "window of opportunity" in the severance tax through which they could make good on their arguments. It provides that:

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[2] Department of Natural Resources and Conservation, "Official Statement, State of Montana Coal Severance Tax Bonds, 1985 Series A", Helena, Montana, page 11.

[3] These purposes are discussed in greater detail in the 1985 Report, pages 4-7.

(1) A coal mine operator is entitled to a new coal production incentive tax credit of 33 1/3 percent of the tax imposed [under the coal severance tax law] on any incremental production produced and sold during calendar years 1985 and 1986.

(2) A coal mine operator is entitled to a . . . credit of 33 1/3 percent of the [coal severance] tax . . . on incremental production for the entire term of an agreement, except as provided in subsection (3), if the incremental production resulted from coal purchases under:

> (a) an existing agreement which was extended between January 1, 1985, and June 30, 1987, for at least a 5-year period; or
>
> (b) a new agreement that was executed between January 1, 1985, and June 30, 1987.

(3) No credit may be claimed for coal produced prior to January 1, 1985. [4]

The amount of the credit is calculated using the arithmetic average severance tax per ton on all sales to a qualified purchaser for an entire calendar year. The incremental production for the year is multiplied by the average severance tax per ton, and that is multiplied by 33 1/3 percent. The resulting credit is claimed by the operator against the following year's taxes, 25 percent of the credit in each quarter.

A total credit of $1,081,848 was claimed on sales in calendar 1985. One-quarter of that ($270,462) was offset against Fiscal Year (FY) 1986 taxes, while the remaining three-quarters ($811,386) of calendar 1985 credits, plus the first one-quarter of calendar 1986 credits (amount unknown at the time this report was prepared) will be offset against FY87 taxes.

Those companies claiming credits and the amounts claimed for calendar 1985 are as follows:

Decker Coal	$814,520
Knife River Coal	2,484
Peabody Coal	194,198
Western Energy	58,138
Westmoreland Resources	12,508

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4 Section 15-25-202, MCA

As to the fiscal impact of the credit:

> The Office of Budget and Program Planning believes that because the existing 30 percent severance tax rate will continue to apply to base contracted levels and the tax credit applies only to incremental qualifying production in excess of base levels, coal severance tax revenues will not be adversely affected. [Its] projections of coal severance tax revenues do not reflect any additional production that might be eligible for the new coal production tax credit, which would increase revenue projections. [5]

3. <u>Water Development Bonds</u>

In addition to coal sales, severance tax rates and credits, and investment earnings, there is one other important factor in determining the level of growth of the coal tax trust fund -- water development bond payments.

Coal severance tax bonds are issued by the state Department of Natural Resources and Conservation (DNRC) "for the purpose of making loans to certain political subdivisions and water users' associations. . . to finance various water development projects . . . ." [6] The enabling act permits the issuance of no more than $250,000,000 in such bonds, and presently authorizes the issuance of only $89,095,528. It is not expected that DNRC will issue the full amount of bonds authorized. The bonds are limited obligations of the state, payable only from loan repayments and coal severance tax proceeds.

The 1985 Report discussed in depth the structure of the DNRC water development bonding program and the planned use of the proceeds of the $10,485,000 1984 Series A bond issue.

Two offerings of coal severance tax water development bonds were made in 1985. The first, for $16,865,000, refunded the 1984 bonds and in addition funded another $5,013,008 in new projects all at a bond rate of 10.118 percent. These included:

Water User	Project Amt.	Terms
Anaconda-Deer Lodge	$ 500,000	Bond rate for 20 yrs.
Charlo	35,000	Bond rate for 20 yrs.

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5 DNRC, *op. cit.*, page 11.

6 *Ibid.*, cover page.

Fort Benton	753,060	3 percent below bond rate for 5 years, bond rate thereafter.
Havre	2,590,000	3 percent below bond rate for 5 years, bond rate thereafter.
Judith Gap	100,000	2 percent below bond rate for 5 years, bond rate thereafter.
Pondera Cons. Dist.	750,000	2 percent below bond rate for 5 years, bond rate thereafter.
Poplar	477,260	3 percent below bond rate for 5 years, bond rate thereafter

The second issue, for $11,500,000 provided for $10,139,944 in new projects at a bond rate of 9.29 percent:

User	Project Amt.	Terms
Cedar Park RID	$ 482,500	4 percent below 1984 bond rate for 5 years; bond rate thereafter.
Cottonwood Dam	45,000	Bond rate.
Denton	185,000	2 percent below bond rate for 5 years; bond rate thereafter
Dodson	32,000	2 percent below bond rate for 5 years; bond rate thereafter
East Bench Irrig. Dist.	1,317,295	3 percent
East Helena	434,434	3 percent below bond rate for 5 years; bond rate thereafter
Ekalaka	195,000	2 percent below bond rate for 5 years; bond rate thereafter.
Glasgow	3,200,000	4 percent below bond rate for 5 years; bond rate thereafter

Hill County Water Dist.	1,410,000	Bond rate
Homestead/Oxbow RID	812,300	4 percent below bond rate for 5 years; bond rate thereafter
Lakeside County Sewer	1,190,000	3 percent below bond rate for 5 years; bond rate thereafter
Lockwood Irrig. Dist.	247,000	2 percent below bond rate for 5 years; bond rate thereafter
Whitehall	154,415	2 percent below bond rate for 5 years; bond rate thereafter
White Sulphur Springs	400,000	2 percent below bond rate for 5 years; bond rate thereafter
Yellow Water Dam	35,000	Bond rate

Given the terms of the loans, with almost all having substantial interest write-downs for the first five years, and with one at below-bond-rate interest rates for the entire term of the loan, it is obvious that repayments will not cover the bonds' debt service requirements. The shortfall will have to be met from the coal tax trust fund's bond debt service account, into which coal taxes destined for the trust are deposited for six months (and invested in the state's Short Term Investment Pool). Semi-annually the amount needed to cover the bond shortfall is deducted from the amount in the debt service account, and the balance is divided between the Board of Investments (75 percent) and the Montana Economic Development Board (25 percent) for their long-term investment activities.

This drawdown of trust funds -- still the only authorized appropriation of funds from the principal of the trust -- is projected by the Office of Budget and Program Planning to total approximately $547,000 per year for the remainder of the decade, calculated only on bonds already issued. Future issuances on comparable terms, of course, would sharply increase that figure. In a time of falling new trust contributions, this should be of concern to the trust's managers.

C. Projections of Trust Inflows to Year 2000

Taking into account all of the considerations discussed above -- declining coal sales, increasing water bond principal drawdowns, and probable lower rates of return on trust investments, it may be useful to draw a picture of the trust's possible future to the end of the century.

In the table on page 13 all numbers given for Fiscal Year 1985 are actual amounts. The figures shown for tax collections and water bond requirements through 1991 are the current estimates of the Office of Budget and Program Planning. The tax amounts reflect an OB&PP-projected 7 percent drop in revenues over the six year period, or an average decline of 1.2 percent per year.

Those predictions are at the low end of the spectrum laid before the Legislature's Coal Tax Oversight Subcommittee at its July 18, 1986, meeting.

> Paul Polzin, researcher for the Montana Bureau of Business and Economic Research at Missoula, predicted the state's 1985 coal production level of about 32 million tons will be maintained this year. The level will increase to almost 37 million tons by 1988 before declining to an average 33 million tons annually through 1993, he said.
>
> A pair of University of Montana researchers, Arnold Silverman and John Duffield, said in a report that Montana's coal industry "will continue a steady growth rate after recovery from the downward economic turn of the past year and a half."
>
> As the recovery takes hold, they said, coal production will reach 42 million tons in 1990 and could be 48 million tons five years later. By 1999, production could be 85 million tons. [7]

One of the major determinants of the magnitude of coal sales is, of course, world oil prices, which are equally difficult to predict accurately.

> "Really, OPEC has run amok," said Scott Jones, an energy analyst at the private consulting firm Chase Econometrics Inc. in Bala Cynwyd, Pa. "Production is out of control."
>
> . . . Bryan Jacoboski, an oil analyst who was observing the [June, 1986, OPEC] talks for the Paine Webber investment firm, also said he expected oil prices to fall as a result of OPEC's stalemate, "but probably not a lot."
>
> Although a majority of the members of the Organization of Petroleum Exporting Countries backed a plan for limiting the cartel's oil production to 17.9 million barrels a day in the October - December period, the proposal was not adopted. The goal would be to push prices up to a range of $17 to $19 a barrel.

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[7] "Coal predictions are widely divergent," Daily Inter Lake, July 21, 1986.

> A hardline minority of Libya, Iran, Algeria and Gabon refused to accept the figures. They wanted more drastic cuts in production to attempt to restore prices to the $28-a-barrel level of last fall. . . .
>
> World oil prices currently are in a range of $11 to $14 a barrel, depressed by the oil glut and OPEC's inability to agree on a strategy for ending it.
>
> "I think we're going to have low oil prices for at least five years," said Philip Verleger Jr., an oil analyst for the consulting firm Charles River Associates of Boston. [8]

Dr. Bill Brown, oil analyst for the Hudson Institute of Indianapolis, Indiana (which has provided largely accurate oil price predictions in past years for clients such as Exxon), says that given the recent oil price "collapse", forecasting methodologies have to be completely re-done. He sees the picture for the next five to six years as "not at all clear" and "just a lot of guesswork,"

Brown regards politics as the main determinant of future prices, and maintains that politics is simply "not predictable." Current low prices are "not apt to last", he says, and thinks prices in 15 years will be "substantially higher." "If anyone gives you a price [prediction] for the Year 2000," he warns, "don't bet on it." [9]

Montana coal sales in FY84 totalled 30.2 million tons, which produced severance tax revenues of $82,823,411, or $2.743 per ton. In FY85, tax collections were $2.739 per ton, on 33.5 million tons; and in FY86, $2.698 per ton on 31.2 million tons. In calculating tax revenues to the Year 2000, an average of $2.70 per ton is used in the table on page 13 for the years 1992 through 2000 (the years not covered by OB&PP's projections).

Assuming that oil prices will increase again, however moderately, and that coal beneficiation processes now under development in Montana will increase the state's producers' competitive position, a 0.5 percent per annum sales increase beginning in 1992 is used by this Report to calculate yearly collections through the Year 2000.

Without knowing whether additional coal tax water development bonds will be issued and, if so, in what amounts and at what rates, any estimation of future trust drawdowns is highly speculative. For the purposes of this Report, no new bonds are postulated, and demands on the trust are projected to decrease as interest write-downs are phased out according to loan terms.

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8 "Oil price decline forecast as agreement eludes OPEC", Missoulian, July 1, 1986, page 18.

9 Dr. Bill Brown, oil analyst, Hudson Institute, telephone interview, July 18, 1986.

A 14.16 percent blended rate of return on Board of Investments and MEDB coal trust investments is assumed in Fiscal Year 1986, 12.31 percent in FY87, 11.36 percent in FY88, 10.35 percent for FY89-91, and 10 percent thereafter. An 8 percent return on STIP investments is assumed in FY86, and 6 percent thereafter.

The "15 percent redeposit" amount is that specified by the 1981 legislature to offset revenue inflow losses caused by water development bond shortfalls and to mitigate some of the adverse effects on the trust's purchasing power resulting from high monetary inflation. (Prior to the passage of the 15 percent law, 100 percent of trust income and earnings were deposited in the state's general fund.)

(Dollars in 000's)

FY End June 30	Tax Collect	50% for Trust		Less Water Bonds		Plus 15% Re-deposit		Avail. for Invest.	Trust Balance
85	91,749	45,875	-	949	+	4,683	=	49,609	$ 253,665
86	84,189	42.095	-	356	+	6,087	=	47,826	301,491
87	80,038	40,019	-	584	+	6,117	=	45,552	347,043
88	82,664	41,332	-	568	+	6,452	=	47,216	394,259
89	85,012	42,506	-	610	+	6,642	=	48,538	442,797
90	83,404	41,702	-	617	+	7,386	=	48,471	491,268
91	85,030	42,515	-	601	+	8,148	=	50,062	541,330
92	85,455	42,728	-	530	+	8,633	=	50,831	592,161
93	85,882	42,941	-	530	+	9,398	=	51,809	643,970
94	86,312	43,156	-	530	+	10,178	=	52,804	696,774
95	86,743	43,372	-	530	+	10,972	=	53,814	750,588
96	87,177	43,589	-	530	+	11,782	=	54,841	805,429
97	87,613	43,807	-	530	+	12,607	=	55,884	861,313
98	88,051	44,026	-	530	+	13,463	=	56,959	918,272
99	88,491	44,246	-	530	+	14,305	=	58,021	976,293
00	88,934	44,467	-	530	+	15,178	=	59,115	1,035,408

The volatility of trust projections can be seen readily when the above calculations are compared with those made in the 1985 Report. There, given what was known or generally anticipated at the time, tax collections were projected to grow an average of 7 percent a year, and an estimated income yield of 12 percent was thought to be conservative. Even bond drawdowns were estimated at only about $300,000 annually.

The result of the 1985 calculation was a projected trust balance in the Year 2000 of nearly $1.8 billion, with annual trust earnings of $200 million. In the space of two years, exogenous political and monetary events have intervened to produce an environment in which a Year 2000 balance of $1.0 billion and annual earnings of approximately $101 million seem more likely.

D. Effects on Trust Purchasing Power

Not all the consequences of the current economic situation are negative, however. With falling oil prices and interest rates, inflation has slowed and, with it, some of the erosion of the purchasing power of trust deposits. In the 1985 Report it was projected that deposits made in 1978 would have lost 39.4 percent of their purchasing power by mid-1984, and that the approximately $200 million in total tax receipts placed in the trust could buy only $178 million in goods and services at 1984 prices, a loss of 10.9 percent of total value.[10]

Likewise, it was anticipated in 1985 that the 1978 deposit would have lost 73.1 percent of its original purchasing power by the Year 2000, and that the seven years' deposits then made would have lost 59.5 percent of their power.[11]

Again using the Consumer Price Index (CPI-U) as a gauge of purchasing power changes, the effect of inflation on deposits made through FY85 can be seen below:

Fiscal Year Ending June 30	Amt. of Deposit to Trust (in $000)	CPI-U ('86 Base) Adjusted to FY End	Value of Deposit in 1985 Dollars (in $000)	Gain/(Loss) Purchasing Power (in $000)
1978	$ 6,262	57.7	$ 3,613	$(2,649)
1979	10,627	63.2	6,716	(3,911)
1980	23,024	71.1	16,370	(6,654)
1981	35,208	79.5	27,990	(7,218)
1982	43,093	86.0	37,060	(6,033)
1983	40,022	89.9	35,980	(4.042)
1984	41,411	93.2	38,595	(2,816)
1985	45,875	97.0	44,499	(1,376)
	$245,522		$210,823	$(34,699)

The additional 15 percent of trust income and interest deposited to the principal in FY84 ($3.46 million) and FY85 ($4.683 million) restored part of the lost purchasing power, but the value of those deposits also has been eroded. In 1985 dollars the FY84 deposit is worth $3.225 million; and the FY85 deposit, $4.543 million, for a net addback to trust purchasing power of $7.768 million.

The 1978 deposit had lost 42.3 percent of its purchasing power by mid-1986. Meanwhile, the $245.5 million in tax deposits made through FY85 had lost $26.9 million in purchasing power (a loss of $34.7 million offset by a $7.8 million net redeposit addback), or 10.6

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10 1985 Report, page 74.

11 _Ibid._, pp 74-5.

percent of total value. (Note: These figures cannot be compared directly with those in the 1985 Report, because those use a 1984 base CPI-U, while the above chart uses a 1986 base.)

Using estimated CPI-U bases derived from Wharton Econometrics Forecasting Associates' most recent (5/86) short- and long-term forecasts, projections to the end of the century can be made. Declines in purchasing power (measured in Year 2000 dollars) of the same eight years' trust deposits would then look like this:

Fiscal Year Ending June 30	Amt. of Deposit to Trust (in $000)	CPI-U (2000 Base) Adjusted to FY End	Value of Deposit in 2000 $'s (in $000)	Gain/(Loss) Purchasing Power (in $000)
1978	$ 6,252	31.2	$ 1,954	$(4,308)
1979	10,627	34.1	3,624	(7,003)
1980	23,024	38.4	8,841	(14,183)
1981	35,208	42.9	15,104	(20,104)
1982	43,093	46.4	19,995	(23,098)
1983	40,022	48.5	19,411	(20,611)
1984	41,411	50.4	20,871	(20,540)
1985	45,875	52.3	23,993	(21,882)
	$245,512		$113,793	$(131,729)

The additional 15 percent of trust income and interest deposited to the principal in FY84 and FY85 totalled $8.143 million, but the value of those deposits will be only $4.193 million in Year 2000.

Using the current CPI-U estimates, the 1978 deposit will have lost 68.8 percent of its original purchasing power by Year 2000 (as compared with 73.1 percent using the 1984 CPI-U estimates). The total seven years' deposits will have lost $127.5 million in purchasing power (the $131.7 million loss shown above reduced by the $4.2 million redeposit residual value) or 50.4 percent of total value (as compared with 59.5 percent in the 1985 Report).

Even under somewhat less inflationary conditions than in 1984, the trust in 1986 continues to lose purchasing power. While the re-deposit of more than 15 percent of income and earnings into the principal (one of the options identified in the 1985 Report) could help stem this tide, such action now is probably even less palatable than it was two years ago. Confronted with the need to cut existing programs and/or raise new revenues to balance the state's budget in future fiscal years, legislators and the executive may find it difficult to shore up the trust by diverting into it revenues now destined for the general fund. For, as was predicted in the 1985 Report, Montana's reliance on trust interest to fund general government operations has become even greater and more urgent.

Total state investment earnings allocated to the general fund (in $000)	$10,664	$53,985	$45,729
Coal trust investment earnings as a percent of total state investment earnings allocated to the general fund	1.7%	21.4%	71.0%
Percent of general fund derived from investment earnings	5.25%	16.86%	13.1%
Coal trust investment earnings as a percent of total general fund revenues (all sources)	0.09%	3.60%	9.3%

The 1985 Report said, "[I]f the principal [of the coal tax trust fund] does not increase substantially, future earnings will be inadequate to maintain the trust's current proportional share of the revenue needed to meet escalating general fund demands."[12] As the table above shows, trust earnings allocated to the general fund increased at an annualized rate of 29.48 percent from 1982 to 1986. Using the tax collection and interest rate assumptions outlined on page 11-13, coal trust earnings available to the general fund in Year 2000 would be approximately $86.0 million. That amounts roughly to an annualized rate of 8.77 percent from 1985 levels, somewhat less than a third of the current rate of increase. Furthermore, that $86.0 million would only be worth $46.9 million in 1985 dollars.

12 *Ibid.*, pg. 83.

CHAPTER 2

TRUST MANAGEMENT

A. Increase Principal Deposits

What can be done to increase the trust's earning capacity? There are a number of alternatives:

1) Increase deposits to the principal

   a) Increase coal sales
   b) Increase severance taxes or reduce severance tax credits
   c) Increase redeposit amounts
   d) Add capital gains on bond swaps to the principal of the trust

2) Increase the rate of return on deposits

   a) Diversify the investments in the trust portfolio within current limitations
   b) Make equity investments with trust funds

1. Increase Coal Sales

As mentioned above, development of new coal beneficiation techniques (to lower the sulphur content of coal, reduce the weight of coal in shipment, increase BTU's per delivered ton, or otherwise enhance the marketability of Montana's coal) could help increase coal sales. Similarly, finding new uses for coal or perfecting less costly ways to extract Montana coal could improve coal sales.

The 1983 Legislature passed Senate Bill 264, allowing beneficiated coal to be taxed at a lower rate. To date, no producer has been able to take advantage of that incentive, but in July, 1986, the Western Energy Company received approval from the new Montana Science and Technology Alliance (MSTA) for a $350,000 loan to assist the firm in commercializing a new beneficiation process. Western Energy estimates that the process, if successfully implemented, should result in the creation of 200 - 250 new jobs in Montana by 1996, and increased coal sales of $38,400,000 per year (at $16 per ton), generating approximately $7.8 million in severance taxes.

The MSTA program was authorized by the 1985 Legislature, and funded with $2 million of alternative energy program money not otherwise expected to be used during the following biennium. If MSTA's efforts prove valuable (and early indications are positive), then some portion of coal trust interest or principal might be used to continue them,

particularly if activities designed to strengthen the Montana coal industry were given funding priority.

Similarly, the Montana International Trade Commission and the Governor's Council on Economic Development have both called for long-range plans to be developed for the revitalization of the state's sagging basic industries, including coal mining. Since a healthier coal industry would, by definition, be a more productive one, the use of coal trust interest to underwrite part of the planning process could pay off in increased coal tax revenues in future years.

2. <u>Increase Severance Taxes or Reduce Tax Credits</u>

It has been suggested (see page 6) that severance taxes themselves can be used to influence the rate of use or development of the resource. If the New Coal Production Incentive Tax Credit does lead to Montana's producers achieving a greater coal market share, then it could be broadened or extended. Conversely, if it fails to prove useful, it could be allowed to expire at the end of the two year trial period. Meanwhile, neither increasing severance taxes above the 30 percent level, nor reducing the royalty deductions, is a viable -- or desirable -- option at this time.

3. <u>Increase Redeposit Amounts</u>

Redepositing more than 15 percent of trust earnings into the principal certainly would improve the trust's defenses against purchasing power losses, and this option was discussed at length in the 1985 Report.[13] In the state's present financial situation, however, this is somewhat unpalatable. One variation on the idea would be to re-deposit a greater amount of trust earnings, while making up the difference to the general fund from the non-trust portion of the coal severance tax, which presently is earmarked for such items as local impact mitigation, county land planning, water development, conservation district grants, libraries, and so forth.

4. <u>Add Capital Gains on Bond Swaps to Principal</u>

The 1985 Report described the accounting treatment being used in dealing with gains and losses resulting from bond swaps.[14] In FY84, the trust had an unamortized deferred gain of $5,912, not a substantial amount. In FY85, however, the trust had a $1,294,397 realized gain on bond swaps, which (added to the 1984 gain of $5,912, but less a 1985 net deferred gain of $7,168) resulted in a fiscal year end unamortized deferred gain of $1,293,141. Were the gain treated as an addition to trust principal rather than as income, the trust would benefit. There continues to be legislative and administrative disagreement over the bond swap accounting issue, and its resolution would be helpful.

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[13] <u>Ibid.</u>, pp. 78-83.

[14] <u>Ibid.</u>, pp. 32-34, 84-85.

B. **Increase Rate of Return**

1. Diversify Investments in the Trust Portfolio

Even if trust deposits cannot be increased in the near term, the rate of return on the existing principal might be improved. The 1985 Report recommended the elimination of the "laundry list" of permissible investments for state fund managers, and the adoption in its place of the "prudent expert" standard.[15]

That action was taken by the 1985 Legislature, at the request of the Board of Investments, and the following provisions added to the Unified Investment Program statute (17-6-201):

> (1) The unified investment program directed by Article VIII, section 13, of the Montana Constitution to be provided for public funds shall be administered by the board of investments and the Montana economic development board in accordance with Article VIII, section 13, of the Montana constitution and the prudent expert principle which requires any investment manager to:
>
> > (a) discharge his duties with the care, skill, prudence, and diligence, under the circumstances then prevailing, that a prudent person acting in a like capacity with the same resources and familiar with like matters exercises in the conduct of an enterprise of a like character with like aims;
> >
> > (b) diversify the holdings of each fund within the unified investment program to minimize the risk of loss and to maximize the rate of return, unless under the circumstances it is clearly prudent not to do so . . . .

According to James Howeth, Board of Investments investment officer, the change to the prudent expert rule changed nothing in the coal tax trust fund's investment goals and objectives. However, he says, there will be some new options for fund investment.

Under the old law, only A rated or better bonds could be purchased by the trust. Under the prudent expert rule, BBB bonds are considered investment grade, and the Board is buying some of those. Although it would not put the entire portfolio into lower grade bonds, it should receive a higher return on those it does buy. The acquisition of a broader grade range of bonds will take effect over a period of time, and will be dependent upon the width of the spread between BBB and higher rated bonds.

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15 *Ibid.*, pp. 85-94.

2. Make Equity Investments With Trust Funds

Howeth points out that adherence to the prudent expert principle would ordinarily require the investment of some coal trust funds in equities to protect the fund in the long term, but equity investments of most public funds are prohibited by the Montana constitution.[16] Amending the constitution to permit equity investments was proposed in the 1985 Report, but while the Legislature discussed the desirability of the amendment, no action was taken to place it before the voters.

This is not a new issue. In 1982, Constitutional Amendment No. 10 appeared on the November general election ballot. It would have deleted from Article VIII, section 13, of the state constitution that sentence which reads: "Except for monies contributed to retirement funds, no public funds shall be invested in private corporate capital stock."

In the argument in favor of the amendment, the advocates said:

> During periods of high inflation . . . fixed rate interest securities tend to lose purchasing power as fast as or faster than interest is earned, thereby eroding the real value of state investments. Permitting corporate capital stock investments gives the State Investment Board more opportunity and flexibility to preserve and enhance the purchasing power of our public monies in today's uncertain investment climate.[17]

The argument against the amendment countered:

> [I]t is not the mission of state government to collect taxes to provide economic or financial relief to those having credit problems.
>
> . . . Now the constitution PROHIBITS the investment of public funds in PRIVATE CORPORATE CAPITAL STOCK but allows retirement funds to be so invested, however statute . . . has restricting limitations on investments with the purpose of protecting state funds while seeking maximum returns.
>
> Retirement funds are long-term investments and may properly be placed in selective private corporate capital stock but public funds, tax generated revenues, which are collected for current expenditures require short-term placement in as safe a market as possible.

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16 Interview with James Howeth, Helena, Montana, June 13, 1986.

17 Secretary of State, "1982 Voter Information Pamphlet", Helena, Montana, pg. 2.

> obviously the constitutional writers thought it unwise to allow public funds to be invested in private corporate capital stock -- that is putting state money in stock in start-up (capital) issues which are not public issues qualifying on a national exchange.
>
> We see no compelling reason to remove this restriction for if removed it might open the door to less conservative practices that even an annual audit might be too late to save.[18]

To which the proponents responded:

> Some state public monies are held for long term. The state's responsibility to maintain the true purchasing power of these funds can only be met during inflationary periods by permitting investments in capital stock which can experience growth. Fixed interest securities inevitably lose value in such times . . . . At seven percent inflation the value of bonds is cut in half every ten years. This amendment will give the State Board of Investments more ability to do their job . . . . [It] is not a license to speculate in unlisted securities as the opponents claim.
>
> If the state monies . . , held in trust for future Montanans, are worth maintaining in real purchasing power, . . . this constitutional amendment . . . improves the opportunity of the state to carry out this trust.[19]

At the time these arguments were being made the Montana Common Stock Pool Fund was made up exclusively of listed stocks of well known firms -- Boeing, Norwest, Monsanto, General Mills, Abbott Laboratories, Pepsico, IBM, Xerox, Exxon, Standard Oil of California, and so forth. Individual retirement funds owned a portion of the pool, rather than holding individual stocks, thereby further lessening the effect on the funds of the ups and downs of particular corporate fortunes.

Unfortunately, Montana voters rejected Constitutional Amendment No. 10, even while on the same ballot they overwhelmingly approved Initiative 95, which set aside 25 percent of new deposits into the coal tax trust fund for investment in Montana. Perhaps the importance of Amendment 10 was lost in the massive publicity and debate surrounding I-95, or perhaps voters were still wary of the perceived risks in letting the state "play the stock market" with their tax dollars.

Whatever the reasons, the defeat of Amendment 10 in 1982 was a blow to the ability of the Board of Investments to manage its portion of the coal tax trust fund in the most prudent manner -- first protecting the safety of the principal, and then maximizing trust returns.

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18 Ibid., pg. 2.

19 Ibid., pg. 3.

Modification of the Constitution to permit coal trust (and other public) funds to be invested in equity instruments should still be a goal of those concerned about the future health of the trust.

3. Other Investment Options

In addition to BBB bonds and common stock purchases, there are a number of other investments that trust managers might make to increase fund returns. Some of these became permissible when the "laundry list" was eliminated, while others require the authority to purchase equities. They include investment in venture capital limited partnership funds, foreign securities, pooled mortgages, financial futures, and "special equities" financing -- all discussed in the 1985 Report.[20]

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[20] Montana Economic Development Board, op. cit., pp. 93 - 96.

CHAPTER 3

IN-STATE INVESTMENTS

A. Current Montana Investments

The 1985 Report traced the progress of the trust through a functional evolution. Initially, the purpose of the trust was "to save money, to keep a portion of tax revenues out of the hands of politicians (however well intentioned) and to transmit the accumulated savings forward to some undefined `future generations'."[21]

As the trust principal grew, however, coal trust investment earnings became a major source of revenue for the state's general fund, and the trust increasingly "came to be valued for its earning capacity, its ability to support general government activities for the current generation."[22]

As part of the 1982 passage of Initiative 95, Montana's citizens adopted a clear definition of how the trust should be used:

> Section 2. Use of the coal tax trust fund for economic development. Objectives for investment of the permanent coal tax trust fund are to diversify, strengthen and stabilize the Montana economy and to increase Montana employment and business opportunities while maintaining and improving a clean and healthful environment.[23]

Moving from savings, to earnings, to investment -- the coal tax trust fund gradually was shaped by voters, legislators, and trust managers. After Initiative 95, however, there no longer could be any question as to objectives of the trust -- the entire trust, not just that portion managed by the MEDB. It was to be invested for economic development purposes.

Clearly that is the aim of all of the programs of the Montana Economic Development Board. The activities, performance, and results of the MEDB's in-state investment program are detailed in that board's own annual report to the Legislature, and will not be repeated here. Suffice it to say that since the MEDB's inception, 52 "coal tax" loans totalling $14,903,959 have been funded or committed, leveraging $2,792,729 in additional private investment, and leading to the creation of 379 jobs for Montanans. Beyond the interest return to the trust on those loans, the state realizes other "long-term benefits"

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21 Ibid., pg E2.

22 Ibid., pg. E3.

23 Secretary of State, op. cit., pg. 24.

(16-6-314, MCA) in job creation, tax base expansion, economic diversification, per capita income increases, and so forth. To the extent that these changes could not have come about or would have been delayed in their coming, or would have been of lesser magnitude without the investment of coal trust resources, the purpose of the trust is being fulfilled.

The in-state investment fund, however, is not the only on-going use of trust resources for economic development purposes. The Board of Investments manages a far larger portion of the trust than does the MEDB. As of June 30, 1985, it had $231,283,217 in trust assets invested as follows:

Corporate Bonds		
Industrial	$52,093,874	
Banks and Insurance	6,285,190	
Other Financial Institutions	2,195,285	
Transportation (excl. Railroad)	5,628,818	
Railroads	2,252,033	
Utilities	64,817,769	
Canadian	20,868,310	$154,141,279
Government Bonds		39,675,045
Government Agencies		16,844,097
SBA Guaranteed Loans		1,139,696
Short-term Securities		100,000
Short Term Investment Pool		19,383,100
		$231,283,217

The Small Business Administration (SBA) guaranteed loans were all to Montana borrowers, and that category of investments represented .5 percent of the fund's assets (1/10 of 1 percent more than in FY84). Federal Avaiation Administration-guaranteed loans to Big Sky Transportation were .6 percent of the fund (down from 18 percent in FY84). The $100,000 Certificate of Deposit was in the Village Bank, Great Falls. Of all the funds in the Short Term Investment Pool, 11.7 percent were in Montana banks, but coal trust STIP funds are almost always placed in Montana institutions. The remainder of the fund was invested in debt securities of firms or government agencies based outside the state, although some of them (K Mart, J.C. Penney, St. Regis, Burlington Northern, Exxon, First Interstate Bancorp, etc.) do maintain plants or facilities in Montana.

In FY85 and FY86 the Board of Investments has reviewed a number of requests for loans to support large Montana development projects. As of June 30, 1986, the Board had outstanding an $8 million commitment to the Columbia Falls Aluminum Company, a new firm organized to take over ARCO's aluminum processing facility in Flathead County when the parent firm divested itself of its mineral operations. If CFAC meets the Board's conditions and draws upon all or part of the $8 million available, the state investment funds for that 600+ employee plant in all probability will come from the coal tax trust.

Although the Board of Investments is a major purchaser of Montana mortgages -- "the only long-term fixed-rate mortgage buyer in the state", according to James Howeth[24] -- these are held almost exclusively in state retirement funds, not the coal tax trust.

The trust, however, does generate significant revenues for the state general fund ($24,371,277 in FY85), and those have been earmarked in part by recent legislatures for economic development purposes. House Bill 500, passed in the 1985 session, stated:

> Section 11. Coal tax trust income. Interest income from the coal tax constitutional trust fund established under Article IX, section 5, of the Montana Constitution is hereby appropriated to the general fund for use during the biennium ending June 30, 1987. The portion of the general fund which represents this appropriation is appropriated to the Department of Commerce in House Bill 500, items 8, 9, 11, and 15, the vocational-technical centers in House Bill 500, and any funds not otherwise designated shall be considered part of the university system's appropriation in House Bill 500.

Item 8 of the Department of Commerce's budget included $1,466,420 for the biennium from the general fund for business assistance programs. Item 9 covered $2,502,164 from the general fund for Montana tourism promotion; Item 11, $408,632 for the community development division; and Item 15, $497,106 for the economic policy and research division -- all major elements in the state's Build Montana program. The $4,874,322 Commerce appropriation for the `86 - `87 biennium represented a 38.3 percent increase over the $3,525,000 economic development fund appropriation for the preceding two years.

B. Loans and Guarantees

The Board of Investments buys few SBA guaranteed loans (only two, totalling $312,700 in FY85), while the MEDB has been much more active in the SBA arena -- 10 loan commitments totalling $4,115,306 in FY85, and 25 loan commitments, totalling $5,756,179, in FY86. The MEDB has also purchased 7 Farmers Home Administration guaranteed loans, totalling $2,555,878.

The Reagan administration's proposal to eliminate or substantially reduce Small Business Administration programs would have a profoundly negative effect on Montana.

In federal FY84, SBA made 519 loans or loan guarantees in Montana totalling $76.6 million. In FY85, the agency made another 519 loans and guarantees for $71.8 million. In addition, it is expected to have made 1,200 to 1,500 disaster loans in the FY85-86 biennium for

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24 Howeth, June 13 interview.

approximately $100 million. As of June 30, 1986, SBA had a 4,499 loan portfolio in Montana of over $350 million, including 1,616 disaster loans totalling $95.2 million.[25]

The widespread availability and use of SBA's guarantee program makes it possible for smaller Montana financial institutions to make loans to their customers beyond their normal lending limits, because the guaranteed portion can be sold on secondary markets. Moreover, the guarantee mechanism makes some loans which are perceived as having a higher degree of risk (particularly in the area of manufacturing) more palatable to lenders lacking expertise or experience in the type of business being financed. Capital availability, or the lack thereof, is cited frequently by Montana businesspersons and economic developers as a barrier to balanced state growth. If the SBA program is cut back, an appropriate use of coal tax trust funds would be to fund a program to fill the gap.

C. Long-term Benefit Criteria

In structuring any program with trust funds, one issue that should concern policymakers is that of "long-term benefit". Section 16-6-314, MCA, states, "In calculating the rate of return for any investment to be made from the Montana in-state investment fund, the [MEDB] shall consider the long-term benefit to the Montana economy." That benefit is defined in 17-6-302(6), MCA, as "an activity that strengthens the Montana economy and has the potential to maintain and create jobs, increase per capita income, or increase Montana tax revenues in the future to the people of Montana, either directly or indirectly."

The 1985 Report examined this concept[26] and concluded that, while the idea of "long-term benefit" is a useful one and might well be extended to cover other state-funded economic development activities, the statutory definition is so vague that measurements of success made against its criteria necessarily will be highly subjective and also may be of limited use in comparing in-state investment program results to those of other state investment efforts.

> [I]f some sort of consistent and generally accepted analysis is desired, the legislature should consider adopting a statutory methodology for computing "long-term benefit" and, further, adding that criterion to all programs wherein state funds are invested in similar private sector activities, such as the DNRC water development and renewable energy program. Over time the legislature can then evaluate the performance of those investments in relationship to that of other state

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[25] John Cronholm, District Director, Small Business Administration, Helena, Montana, telephone interview, July 21, 1986.

[26] MEDB, op. cit., pp. 97-102.

> funds, and determine whether to increase or diminish the percentage of resources devoted to this purpose.[27]

One of the obvious candidates to have "long-term benefit" criteria included in its evaluation procedures is the new Montana Science and Technology Alliance program, and the criteria could be applied as well to future activities of older, existing development programs. If the state is going to continue to direct large amounts of tax revenues and investment earnings into economic development programs, it must formulate some satisfactory, consistent, and comparable means for measuring their results. Only then can scarce resources be allocated responsibly.

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27 Ibid., p. 98.

CHAPTER 4

USING THE TRUST PRINCIPAL

A. Principal Appropriation Issues

> We should not be short sighted and spend all our tax income as rapidly as we earn it.
>
> Further, we become addicted to all coal monies in support of the state's day-to-day operations . . . . [W]e will be severely punished financially on the day when the coal no longer exists or has value.
>
> . . .Legislators know how tempting it is to dip into the coal tax monies with this and that "worthy project" until in the distant future there is nothing to serve as a revenue generating investment base. The proposals for use of coal tax revenues have already started mounting and pressures will be placed on the next session of the legislature to carve out more and more of the tax revenues for all sorts of "worthy projects."
>
> By passing this amendment we will guarantee an endowment for the future and avoid temptations to spend it now.[28]

The dire warnings could have been written today -- instead of in 1976. The proponents of the creation of the coal tax trust fund continued:

> If such a trust is not established, all the money that we derive from the taxes on coal will be gone when the coal is gone. The money from the coal tax should be handled with all future generations in mind, not just this one.
>
> . . . With the trust, [the legislature] can only dip into the principal if they can garner a 3/4 vote of each house of the legislature. Such a vote is extremely difficult to achieve without proving a compelling necessity.[29]

Oddly enough, the opponents' (some themselves legislators) also expressed fears about the Lorelei-like effect created by a large pool of available money:

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[28] Secretary of State, "Voter Information for Proposed Constitutional Amendments -- Referendums -- Initiatives", Helena, Montana, 1976, pg. 3.

[29] Ibid., pg. 5

> [I]t is questionable that such vast accumulation of funds should be controlled by politicians. The larger the accumulation of trust funds, the greater the temptation will be for future legislators to spend the principal.[30]

B. Recommended Appropriation Criteria

Yet the creators of the trust clearly intended that the principal of the trust could be appropriated, <u>if</u> a "compelling necessity" could be proved.

The first and, so far, the only such appropriation was that made through the enactment of the coal severance tax (water development) bond program by the 1981 legislature. (Initiative 95 mandated a redirection of a portion of the trust's investments, but did not authorize the expenditure of any of the trust principal.)

Initiative 95 did establish, however, a dual purpose for the trust: (1) to compensate future generations for the loss of the coal resource, and (2) to develop a stable, strong, and diversified economy for present, as well as future Montanans. It is in light of that charge that all decisions regarding investment or expenditure of trust resources must be examined.

Since the trust's settlors failed to define what would constitute a proper justification for appropriation of trust principal, and since no legislature since then has done so, the MEDB in its 1985 Report suggested some criteria which appeared defensible at the time:

> 1. The body of the trust should never be appropriated (or borrowed, as in Colorado's current situation) for use in meeting general government expenses. These are the proper responsibility of the current generation, and should not be subsidized to the detriment of the future.
>
> 2. Whenever possible, amounts appropriated from the trust should be replaced, with interest, at some future time. That means that expenditures from the trust preferably should be for revenue-generating purposes.
>
> 3. Amounts not otherwise available that are needed to mitigate the impacts of coal development (or mine closures) are statutorily eligible to be appropriated from the principal.
>
> 4. No appropriation should be made unless the identified need has been thoroughly documented, studied, and found to be "compelling", with no other financial resources available to

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30 <u>Ibid.</u>, pg. 4.

meet it. Representatives of the trust's beneficiaries should be involved in the evaluation, and their findings made public.

5. The benefits to be gained through the appropriation must outweigh both the losses in earnings that will result and the negative impact of those losses on activities supported with trust earnings. Expected economic development benefits should be clearly defined and, if possible, quantified prior to appropriation, and should be closely monitored and evaluated thereafter.

6. Programs or activities undertaken with appropriated trust funds must have long-term value to the state, helping correct structural or systemic imbalances in the economy, for instance, rather than dealing solely with short-range cyclical problems.

7. Insofar as possible, benefits accruing from trust appropriations should inure to all citizens, not just to particular industries, geographic areas, or interest groups.[31]

C. Borrowing from the Trust

The Colorado situation referred to in the first criterion was one in which the 1983 Colorado legislature, confronted with a severe state revenue shortfall, created a fiscal emergency fund into which went the uncommitted principal and interest earnings on: (1) the state's highway users tax fund, (2) the Colorado water conservation board construction fund, (3) the lottery fund, and (4) the state's severance tax fund. By June 30, 1985, all monies borrowed from the various funds were to be restored, using revenues derived from a temporary increase in state sales and use taxes.

Colorado's severance tax trust "is to be perpetual and held in trust as a replacement for depleted natural resources and for the development and conservation of the state's water resources . . . ."[32] In FY82-83, $50 million was borrowed from the trust, and in FY 83-84 another $24.8 million -- all told, about 80 percent of the trust's assets.

In FY85-86, the entire $74.8 million, but without interest, was repaid into the trust fund -- and immediately transferred out again to the state's capital fund. Legislative opinion at that time was that the need for the trust was no longer paramount, and that other state needs took precedence. There is still approximately $20 million of the original balance remaining in the trust, and new deposits (50 percent

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31 MEDB, op. cit., pp. 112-3.

32 39-29-109, Colorado Revised Statutes.

of total gross severance tax receipts) continue to be made. (Incidentally, the temporary sales and use taxes were discontinued after the various funds had been repaid.)[33]

"Borrowing" from the trust fund, as the Colorado experience shows, can easily turn into a backdoor appropriation, and should never be done to cover shortfalls in revenues for general government expenses. Such a "quick fix" for temporary financial problems only delays the making of curative decisions, and in no way meets either of the statutorily defined trust purposes.

D. Diverting Trust Inflows Temporarily

Some Montana lawmakers introduced a variation on the "borrowing" theme during the June, 1986, special session.

Senate Bill 16 proposed to transfer "to the general fund for the fiscal year ending June 30, 1987, $39,000,000 from the money flowing into the trust . . . ." Any funds remaining unexpended at the end of the year would then be retransferred to the trust.

> In a wide-ranging floor debate, opponents argued that tapping the trust for general spending not only goes against the intent of the fund, but also fails to address the crux of Montana's financial crisis: Government is spending more money than it takes in.
>
> But supporters of SB16 said the severity of Montana's economic crisis justifies cutting into the trust income.
>
> Sen. Allen Kolstad, R-Chester, the bill's other co-sponsor, pointed out that it removes no money from the trust account, which contains nearly $300 million.[34]

While this particular proposal failed to pass, the concepts it embodied are worth exploring. First, it was suggested that the revenue shortfall facing the state was a "crisis" and that the present time was the "future" envisioned by the trust's creators.

The constitution is silent on the entire "future" question. Statute says the trust purpose is "to compensate future generations" and to develop a healthy economy for Montanans "both now and in the future". The trust has been in existence for eight years (from 1978 - 1986), so it is unlikely that Montanans today qualify as a "future generation" in

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[33] Chris Blackwood, economist, Colorado Office of State Planning and Budget, telephone interview, June, 1986.

[34] "Senate nixes proposal to use coal trust fund," Missoulian, June 24, 1986, page 7.

terms of the trust. Meanwhile, using trust resources to meet general fund revenue shortfalls does little to develop a future economy. It simply relieves today's pains by deferring them toward the future. Arguably, then, using the trust in the manner suggested flies in the face of the trust's purpose, and fails to meet criteria 1 and 6 outlined above.

Also, appropriating trust revenues quickly to meet recently discovered shortfalls forecloses the possibility of thorough study of the possibly "compelling" nature of the problem. (Criterion 4)

Aside from the proposition that now is part of the future, diverting trust inflows even for a short period would have a disasterous effect on future trust purchasing power. Lacking adequate internal protection from inflation, the trust must rely on new deposits to maintain its strength. Since the proposal did not mandate repayment, with interest, it fails criteria 2, as well as 5.

Finally, diverting all or a major portion of new deposits to the trust would essentially terminate for the period of the diversion any new in-state investment by the Montana Economic Development Board's coal tax loan program, mandated by the voters through Initiative 95. The economic development purpose of the trust would be compromised, to the detriment of new or expanding locally-owned enterprises. (Criteria 1, 2, 5, and 6)

House Bill 20, also introduced in the special session, would have "appropriated from the coal severance tax bond fund of the coal severance tax trust fund to the Board of Regents of Higher Education $17,736,955 of the receipts deposited in the bond fund between July 1, 1986, and June 30, 1987," to offset any general fund appropriations to higher education which might have been eliminated or reduced by another act of the special session.

This proposal did speak to the needs of future generations (statute gives no guidance as to how far in the future its "future generations" lie), and could have fallen within the bounds of trust purpose if education were viewed as being linked with the development of a healthy economy -- a defensible position. The appropriation would have been permanent, however, with no provision for repayment (although with a requirement for reversion of unspent funds), and thereby was in conflict with criterion 2.

Of greater concern is the issue of "compelling" necessity. Since the authors of HB20 proposed diverting nearly one-half of 1987 trust revenues to higher education at the same time as they apparently saw other legislators prepared to cut general fund support for those same activities, there appears to have been some disagreement among knowledgeable people as to the severity of the problem. Criterion 4 was not met at the time of bill introduction.

Finally, cutting trust inflows cuts future trust earnings. Since a major portion of trust income (over $20 million in FY85) is used to support vocational-technical centers and the university system, their future revenues would have been diminished in the process of giving more money to higher education in FY87. It is not clear that Montana's present or future economy would benefit if long-term support for vocational and higher education programs were cut. Criterion 5 may not have been met.

E. Diverting a Portion of Trust Inflows Permanently

House Bill 18 would have altered the 15 percent redeposit provision to provide for a redeposit of only 13 percent, with the remaining 2 percent to be deposited in a coal tax criminal investigation account.

The critical question here seems to be whether the benefits of the criminal investigation effort would outweigh the loss to the trust. Given that the 15 percent redeposit already has been shown to be inadequate to protect the trust's purchasing power, and given no clear economic development benefits from the criminal investigation program (however otherwise worthwhile), criterion 5 was not met.

In that police functions are considered general government activities, criterion 1 also was not met. Furthermore, the permanent diversion would by definition preclude trust repayment, thereby failing criterion 2. Finally, no thorough documentation is available to show that the need for the criminal investigation program is so "compelling" that trust funds must be tapped as a last resort to provide it, as would be required to meet criterion 4.

If the criminal investigation activities were to take place in coal impact areas, and were made necessary as a result of coal development -- and if there were no monies otherwise available to meet the need -- then criterion 3 would have been met.

F. Appropriate a Portion of the Existing Trust

House Bill 8 said simply, "There is appropriated $24,000,000 from the coal severance tax trust fund to the state general fund to be used in fiscal year 1987."

This proposal failed criteria 1 through 6. Its intent was to appropriate approximately 8 percent of the entire trust principal to meet current general government expenses (#1). It suggested no future replacement, with or without interest (#2). It had no coal development impact mitigation effect (#3). It demonstrated no compelling need which could not be met by other means (#4). It did not embody any economic development purpose, nor show that the benefit of this one-time transfusion to the general fund would outweigh all the downstream trust earning capacity lost as a result of the appropriation

of the $24 million (#5). And, finally, it did nothing to address the structural or systemic problems that led to the revenue shortfall it intended to make up (#6).

One other proposal for trust appropriation was discussed prior to the special session:

--A measure by Rep. Rodney Garcia, D-Billings, would allocate $100 million from the permanent coal tax trust fund to use in repairing public works.[35]

As the 1985 Report pointed out, citing the Governor's Task Force on Infrastructure's September, 1984, draft report:

-- In just the 127 incorporated communities in the state, $100 million is needed for water supply system repair
-- Montana's 203 public sewer systems require an estimated $231 million to bring them up to current health standards
-- Over $8 billion would be needed to bring the network of roads and streets maintained by local governments into good condition

Representative Garcia's proposal (which failed to garner enough support for introduction as a constitutional amendment) would have appropriated nearly 40 percent of the trust's principal, and would not even have covered half the need for sewer systems alone. Compared to the staggering needs of road and street programs around the state, it would be somewhat akin to throwing a teaspoon of water on the towering inferno. Quite simply, we could expend the entire trust on infrastructure repairs, and still barely dent the problem, while at the same time strangling state economic development and education programs.

Not that the proposal was without merit or precedent. The Canadian provinces of Alberta and Saskatchewan have made massive expenditures from their mineral trusts for infrastructure programs. As the 1985 Report said:

> Although many of those activities are not direct revenue producers, they can be justified on the grounds that they support economic and social development programs which contribute to the security and stability of future generations.

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35 The Daily Inter Lake, "Majority of legislators' bill drafts doesn't follow governor's special-session agenda", Kalispell, Montana, June 3, 1986, pg. A-3.

A further argument is made that by constructing the projects now, money is actually saved, since construction costs in the future would inevitably be greater.[36]

Criteria 7, and possibly 4, were met in whole or in part by the proposal for infrastructure. It faltered at Criteria 5 and 6, however, where the trade offs between temporary improvements in public works (which will start to deteriorate again as soon as repairs are completed) and long-term economic development benefits must be weighed. If the trust principal were to be appropriated in this case, it would be gone forever. There was no provision for replacement. Would the new or expanded economic activities which the infrastructure improvements might support have generated enough new revenue to compensate for the loss of trust income and investment capacity? Without a description of the specific projects to be undertaken it would have been difficult to reach a conclusion.

One possible alternative is suggested by the Board of Investment's James Howeth, who says it would be "almost unbelievable to cash in the principal and spend it on buildings or bridges."[37] He points out that the trust is tax free, and says the economical way to build infrastructure is to issue municipal bonds, which are tax exempt, and use trust earnings (not principal) to pay off the bonds. If you earn 12 percent tax free on the fund, he continues, and you sell the bonds at 8 - 9 percent, you will also make a spread on the investment rate.

Minnesota, New Mexico, North Dakota, and Wyoming use all or a portion of the interest from their severance tax trust funds for infrastructure projects, generally to repay bonds issued by the state or local government jurisdictions.

G. Stop All Future Trust Inflows

Senate Bill 23 proposed to submit to Montana voters the repeal of Article IX, Section 5, of the Montana constitution, which establishes the coal tax trust fund.

> Proponents said the bill would make it easier to lower Montana's 30 percent coal severance tax, which they said is hurting the state's coal industry and costing jobs.
>
> Opponents, however, said it was a bad idea to halt income to the trust fund and that [Senator Thomas] Keating's bill was misleading . . . .

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36 MEDB, op. cit., pg. 117.

37 Howeth interview, June 13, 1986.

> [Keating] argued . . . that the bill would be the first step toward lowering the coal tax because it would allow lawmakers to reduce the tax without reducing the amount it contributes to other government programs.
>
> "My referendum says cap the permanent trust fund," he said. "[The fund] does not serve a useful purpose . . . . There is no need for a legacy on the basis that coal will be mined out and we will be left barren."[38]

The effects of Senate Bill 23, had it passed, would have been sweeping. If Article IX, Section 5 of the constitution were repealed, those laws affecting the trust (including the requirement of a three-fourths vote of each house for trust appropriation) thereafter could be amended by a majority vote of each house. There would no longer be a mandate to deposit a portion of severance tax revenues in the trust. The in-state investment fund created by Initiative 95 would have lost its source of funding. The pledged tax revenue source which guarantees the state's water development bond program would have been eliminated, thereby imperiling future bond sales, while at the same time striking at the safety of the guarantee of outstanding issues.

Although on the face of it this bill would not have appropriated any of the existing principal of the trust -- only capped it at its current level of approximately $300 million -- in all likelihood total appropriation would have occurred within a short period of time for two reasons.

First, without the three-quarters vote protection, the trust would be much more vulnerable to raids in times when state revenues fell short of desired or planned expenditure levels. It is only necessary to look back at the votes on coal trust-related issues in the June, 1986, special session to see how easily this could occur.

Secondly, a capped trust, especially if shorn of its 15 percent redeposit protection, would quickly start to lose substantial purchasing power. At that point it might become logical to spend the trust for infrastructure or other long-range programs rather than let it wither to the point where it no longer had the resources to significantly impact the state's economic future.

The determination of the appropriate level of Montana's coal severance taxation is beyond the scope of this Report, but SB23 raised a number of important related issues which should be explored as part of any future debate of the question.

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38. "Attack on coal-tax fund loses", Daily InterLake, June 29, 1986, page 1.

The first, of course, is how important the trust is to Montana. Do present and future generations need to be compensated for the loss of a part of their natural heritage? If so, at what level? If the severance tax were to be halved, for instance, does it automatically follow that all trust contributions should cease, and the remaining tax collections be used solely for non-trust purposes -- libraries, county planning, parks, highways, and so forth.

It would be useful at any future time that tax reduction might be considered to re-examine the state's purpose in levying a severance tax, and to determine whether some portion of it (however reduced) should still be placed in a trust. Some effort should also be made to weigh the long-term economic impact of jobs anticipated to be created or saved through lower severance taxes against the impact of jobs created or saved and economic activity fostered through the in-state use of trust resources.

If the trust were to be capped, what then would become of the MEDB's in-state investment program? Since the voters decided in 1982 that one-quarter of new revenues flowing into the trust should be used to fund the MEDB loan program, it would seem logical that, if there were to be no more new revenues, one-quarter of those funds already placed in trust should be given to the MEDB to administer. That would be true to the intent, if not to the specific language, of Initiative 95. A similar set-aside might also be appropriate for the support of the water development bond program.

Even if capped and rendered more accessible, the coal tax trust fund still would have to be used for the purposes established in statute for it:

> (1) to compensate future generations for the loss of a valuable and depletable resource and to meet any economic, social, and environmental impacts caused by coal development not otherwise provided for by other coal tax sources; and
>
> (2) to develop a stable, strong and diversified economy which meets the needs of Montana residents both now and in the future while maintaining and improving a clean and healthful environment . . . . [17-6-303]

To safeguard the rights of the beneficiaries, it would be even more necessary then than it is now to have established clear, justifiable criteria and procedures to be used in evaluating proposals for the use of trust funds.

Finally, since the perpetual status of the trust would no longer be assured, the trust's remaindermen should be designated, and the terms and conditions specified under which the trust could be dissolved.

H. Conclusion

None of the foregoing is intended to suggest that no portion of the coal tax trust fund principal should ever be appropriated. On the contrary, as was discussed in the 1985 Report, there may be any number of meritorious potential uses of the trust for economic development purposes which may emerge in the future and meet all or a majority of the appropriation criteria outlined above. That we have not yet encountered those ideas does not mean that they do not exist, only that they have not yet been presented for public debate.

If the trust is to be appropriated in any case short of a true state emergency (the "compelling" necessity), it must be for activities that anticipate and meet in advance the needs of future generations, that broaden and multiply their and our economic opportunities and options. The trust can be the impetus that propels Montana forward through the transition from an economy based on simple extraction to one in which substantial value is added to the state's vast natural resources. It can help position Montana competitively in the new world economy wherein ideas are the raw materials of industry, where satellites and telecommunication networks diminish forever geographic barriers, and where scientific discovery and technology transfer can be brought to bear on solving the state's structural and systemic problems. It can be at least part of the means through which we create a strong, aggressive, diversified, and healthy Montana.

The coal tax trust fund is today's legacy to the future. It challenges citizens and lawmakers to think beyond their daily problems and desires, to lift their ideas and aspirations beyond their own needs. In a state built on a pioneering tradition, the trust gives Montanans the resources to conquer the newest frontier.

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